

Practice questions for Chapter 19 – Incorporation and bodies corporate

Essay question

Otto Khan-Freund famously described *Salomon v A Salomon & Co Ltd* as 'a calamitous decision.' Discuss the impact and importance of the case and the justifications behind the decisions of the various courts.

Introduction

- Point out that this essay will discuss the case of *Salomon v A Salomon & Co Ltd*. Also state that *Salomon* is one of the most important cases in company law

Salomon

- As incorporation became more popular in the late nineteenth century, businesses previously conducted as partnerships or sole-traders increasingly decided to incorporate. The business would be sold to a newly created company whose only members would be the previous owner or owners, and sufficient nominees to make up the minimum number of persons.
- Normally, you will not be required to provide the facts of a case when writing an essay. However, where the essay requires you to discuss a single case, setting out the facts of the case is often useful.
- Mr Salomon had conducted his bootmaking business as a sole trader, and he sold it to a newly incorporated company. The only members were himself, his wife, his daughter and four sons (the minimum number of members at the time was 7.) Each of these took one £1 share. The business was sold to the company for £39,000, and part of this money was used by Mr Salomon to purchase a further 20,000 £1 shares (this meant he had 20,001 shares and the remaining 6 members had 1 each). The remainder of the price was paid for by debentures and the granting of a floating charge to Mr Salomon.
- Almost immediately the company ran into problems and only a year later, the company went into liquidation. Unfortunately, whilst there were enough assets to pay off the debenture holders and Mr Salomon (as he was a floating charge holder), there was no money left to pay the unsecured creditors.
- The company liquidator took a stand against Mr Salomon and stated that, instead of taking money out, he should be personally liable for the debts, just as if he was still a sole trader. More specifically, the liquidator claimed that:
 1. the price the company paid for the business was excessive
 2. the arrangements made by Mr Salomon in relation to the formation of the company constituted a fraud on the creditors, and
 3. no board of directors were ever appointed or, if there was a board, it consisted solely of Mr Salomon, so there was never an independent board.
- At first instance, Vaughan Williams J was not prepared to grant relief based on the liquidator's claims, but he did grant relief based on the concept that the company was an agent or nominee for Mr Salomon. He therefore ordered that Mr Salomon indemnify the liquidator.
- The Court of Appeal upheld the trial judge's decision stating that the whole transaction was contrary to the true intent of the Companies Act, and that the company was a sham and an alias, agent, trustee or nominee for Mr Salomon. Also the Court of Appeal was in no doubt that when Parliament stipulated seven members, it meant seven genuine and active members. As such, Mr Salomon was personally liable to indemnify the company for its debts.

- The House of Lords unanimously reversed this decision. It held that the company was validly formed since the Act merely required 7 members holding at least one share each. The Act said nothing about them being independent or that they should take an active role in the company.
- It was argued that Mr Salomon had perpetrated a fraud by significantly overvaluing the company at £39,000, but the House disagreed stating that all the members were fully conversant with what he was doing.

Justifications

- The decision in *Salomon* can be justified in a number of ways. It encourages individuals to set up businesses by making it less risky. This is certainly true. However, as a corollary, certain individuals will set up companies that are under-capitalised, content in the knowledge that, should the company fail, they will be protected by the company's separate personality. Accordingly, the ability to use corporate personality to shield oneself from liability may encourage the setting up of unstable businesses which will have a negative effect on the economy. This, ultimately, makes business more risky for everyone. Parliament has responded by attaching personal liability in certain circumstances.
- Some argue that the market for shares relies on the ability to shield oneself from liability. Without it, shareholdings would be limited to a few wealthy investors who can monitor their shareholdings. Small investors would be deterred from investing by the prospect of unlimited personal liability. Further, shareholders often diversify their shareholdings across a large number of companies to minimise risk. If investors could not shield themselves from liability, diversification would increase the shareholders' risk, not decrease it.

The impact of *Salomon*

- The decision of the House of Lords in *Salomon* is often credited with establishing the concept of separate personality. This is not true – the concept of corporate personality was recognized long before 1897, and was a clearly intended consequence of the Joint Stock Companies Act 1844.
- What *Salomon* did was to demonstrate that the courts had not, until then, fully appreciated the consequences of separate legal personality. In upholding the separate personality of the company even where the individual's control of the company was absolute, the House of Lords established that the corporate form could be used legitimately to shield an 'owner' of the business from liability.
- *Salomon* has shown itself to have had a significant impact on the content of company law. Whilst the company remained a private institution composed of people, it was possible to leave the regulation of the company to its members, subject to a few mandatory requirements.
- However, with the emphasis which *Salomon* placed on the institutional nature of the company, and the resultant relegation of the members' interests, oversight by the members became more unlikely and more difficult. The upshot of this was that the State came to play a greater role in the regulation of the company.
- Note that although *Salomon* is famous for propagating the concept of separate personality, it also propagated concomitant benefits of incorporation, notably limited liability.
- Whilst the recognition of the ability to shield oneself from liability is the primary impact of *Salomon*, two other notable consequences of the decision also should be noted.
- First, *Salomon* implicitly recognized the validity of the one-man company (that is, a company run by one person with a number of dormant, nominee members) long before company law overtly allowed one-man companies to be created. The ability to create a one-man private company was only granted in 1992, and the ability to create a one-man public company was established by the CA 2006.
- Second, *Salomon* established that a relationship of agency or trusteeship will not be created simply because a person holds shares in a company (even if he owns all the shares).

Essay question

The general belief is that the principle of limited liability unfairly shifts the risk of corporate failure from a company's shareholders onto its creditors. Do you agree?

Introduction

- Begin by briefly defining what limited liability is and state its importance. The majority of persons who choose to incorporate a business do so in order to acquire limited liability. However, limited liability is still controversial in some respects, especially in relation to its effects on a company's creditors. In this essay, these effects will be discussed.

The argument

- First, it is worth briefly discussing a typical debt contract. The rate of return which a creditor earns if the company repays the credit amount and interest on time is known as the yield. The yield is fixed by the debt contract. The reason why creditors face risk is due to the fact that the yield on a debt obligation is only a promised rate of return. This is important because there is always the possibility that the debtor company will breach its obligation to repay the creditor. The possibility that the creditor will not be repaid is known as the default risk. The default risk faced by creditors increases significantly if the company is in financial trouble. Upon liquidation, the creditors have priority over the shareholders.
However, if the company's debts exceed its assets, not every creditor will be paid. For this reason, corporate debt is never risk-free because any company, no matter how successful it may appear to be, can fail to repay its creditors.
- The general position adopted by most commentators is that when the company is successful, the risks faced by the shareholders and creditors will be very low because the value of the company's equity will be rising and so the risk of default will be low. However, this is not always the case. Conflicts between the shareholders and the creditors can exist which serve to increase a creditor's risk, even if the company is highly successful.
- For example, a conflict can occur where a company decides to borrow capital. This is something that the shareholders may view favourably since it means that the members will not be asked to provide additional funding. With new funds, the company may also be able to pursue potentially profitable transactions that it could not previously afford to pursue. Existing creditors will not view the new borrowing so favourably. As their return is fixed, the possibility of higher profits will make little difference to the creditors. However, an increase in borrowing will increase the company's debt-to-equity ratio. This will dilute the claims of the existing creditors, thereby increasing the risk that they will not be paid fully.
- It can therefore be seen that even when the company is profitable, the shareholders have the potential to increase the risk faced by the creditors. However, the real conflict between the shareholders and the creditors occurs when the company's solvency is in doubt. It is the shareholders' position as beneficiaries of limited liability that increases the creditors' risk and it is to this that we now turn.

Creditors and limited liability

- Henry Manne¹ has correctly argued that without limited liability, many small shareholders could not invest in public corporations. He argues that if investors were required to supply unlimited amounts of capital, wealthy people would be reluctant to make small investments. Every equity holding, no matter how small, would place the shareholder's personal assets at risk. Manne argues that limited liability eliminates this risk.
- Many commentators² however, do not share Manne's view that limited liability solely minimizes shareholder risk. Instead, they argue that it minimizes shareholder risk by shifting the risk from the shareholders onto the creditors. The theory is as follows.
- There is little doubt that limited liability encourages directors to engage in risk-taking activity of behalf of the shareholders. As shareholders are able to share in the gains of corporate growth without risking more than their initial investment, investment is made on the basis that those in charge will take risks in order to pursue and exploit potentially lucrative projects and ventures. There is little doubt that this risk-taking is beneficial. As Sealy notes, without limited liability, the world's railways would not have been built and many of today's information technology companies would not have got off of the ground.³
- However, limited liability also increases the default risk faced by the creditors. Limited liability induces the shareholders to gamble with the creditor's money. Take the following example. A company has an issued share capital of £100. The directors then borrow £10,000 on the company's behalf. If the company does well, the shareholders will reap most of the benefit in the form of increased dividends and rising share price.
- However, if things go badly, then the shareholders only lose their initial £100 investment, whereas the creditors will receive little, if any, of the £10,000 which the company owes. This temptation to gamble with the creditor's money is compounded when the company nears insolvency. It may be the case that a company cannot avoid insolvency. In such a situation, the shareholder's investment is lost, whereas the creditors will be concerned that they will not receive what they are owed. The responsible thing to do will be to wind up the company and keep any remaining funds inviolate in order to repay the creditors.
- However, Sealy argues that limited liability creates a perverse incentive for an insolvent company to continue to trade.⁴ As a company approaches insolvency, instead of winding up the company, limited liability induces the company to partake in risky investments which, if successful, will result in a bonanza payoff. The rationale for this course of action derives from the shareholders' limited liability. If the risk is worthwhile and the company trades out of difficulty then the shareholders will benefit from the gains. If however, the risk does not pay off, then the shareholder's investment is lost, so any additional losses will be borne by the creditors. Because of this, investing in a limited liability company as a shareholder has been described as a 'heads we win, tails creditors lose' situation. Accordingly, shareholders have an incentive to gamble with what the creditors have at stake.
- It can therefore be seen that creditors face substantial risks and that those risks increase as a company's fortunes dwindle. The creditors risk increases whereas the shareholders does not due to the existence of limited liability. Conversely, many commentators argue that limited liability creates an externality in that the shareholder's risks are passed onto the creditors. As a matter of risk *per se*, this conclusion cannot be doubted. The presence of limited liability and default risk increase the risks

¹ H Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53 Va L Rev 259.

² See e.g. JC Coffee, 'Shareholders Versus Managers: The Strain in the Corporate Web' (1986) Mich LR 1, 61; DD Prentice, 'Creditors' Interests and Directors' Duties' (1990) 10 OJLS 265; RA Posner, *Economic Analysis of Law* (4th ed, Brown 1992) 394.

³ L Sealy, 'Directors 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural' [1987] Monash Univ LR 164, 181.

⁴ DD Prentice, 'Creditors' Interests and Directors' Duties' (1990) 10 OJLS 265, 277.

faced by creditors. However, as regards the creditors, the issue of risk is more complex as creditors have the ability to protect themselves from the increase in default risk that limited liability can create.

Can creditors protect themselves?

- Traditionally, UK company law has taken the position that the shareholders should be the sole beneficiaries of company law protection because they are affected most by fluctuations in corporate performance, whereas other constituents contract for fixed amounts and so do not value protection so highly. However, the presence of default risk means that even though a creditor contracts for a fixed amount, the amount that he receives cannot be predicted with certainty. Instead there are a number of indeterminate outcomes from full and timely payment to complete default. This variation means that there is a volatility risk associated with corporate debt. In this part of the essay, you may want to discuss the extent to which the creditors can protect themselves from the increased risk of default that limited liability can create.
- The most obvious way that creditors can protect themselves is through the debt contract through the use of consensually negotiated contractual terms. A typical debt contract will provide for a repayment date and the interest that is due. The interest rate that a creditor contracts for represents not only the cost of renting capital (that is, lending money), but it also takes into account the possibility that the debtor will not repay the loan (that is, the default risk is a factor in determining the interest rate).
- Although the law allows borrowers to shift the risk onto creditors, the risk is fully compensated by the higher interest rate. Creditors receive more money (in the form of greater interest) for the increased risk that limited liability can result in. Accordingly, if the creditor believes that default is a possibility, he can contract for a higher interest rate. For example, banks will require a higher interest rate if a borrower is not credit-worthy. Risk may be passed onto the creditor, but the creditor is fully compensated for bearing this risk by the higher interest rate, and if a creditor does not contract for a higher interest rate, the law should not support his shortsightedness.
- It can therefore be seen that manipulation of the interest rate can theoretically be used to compensate the creditors for the shifting of risk caused by the shareholders' limited liability. However, as we have also seen, it is an imperfect solution. Smaller creditors may lack the power to bargain effectively with large companies to obtain an interest rate that will fully compensate them for the increase in risk.

Conclusion

- Conclude based on the arguments you presented. There is significant debate in this area. Most academics agree that limited liability does shift risk from the shareholders onto the creditors. On this basis, some argue that creditors need to be better protected.

Problem question

Vic Mortimer and Bob Reeves are partners in a business that sells video games hardware and software. The business proves to be extremely successful, and they open up a number of branches in the local area. In order to limit their liability, they instruct their solicitor to incorporate the business, calling the new company 'Hampshire Gaming Ltd.'

Around the same time, Soony are about to release a new games console – the GameStation 4. Vic and Bob are eager to acquire as many of these consoles as possible as they are likely to prove highly profitable. Vic hears of a potential source (Soony Console Suppliers Ltd), and is offered 50 consoles. Eager to purchase the consoles, Vic does not wait until the company is incorporated and enters into a

contract 'for and on behalf of Hampshire Gaming Ltd' with Soony Console Suppliers Ltd.

Bob also is offered a number of consoles and, prior to incorporation, enters into an agreement with Gaming Hardware Ltd to purchase 40 consoles. Bob signs the agreement 'Hampshire Gaming Ltd pp. Bob Reeves (a director).'

The certificate of incorporation is issued and, at the first board meeting of the new company, Vic and Bob ratify both agreements. Shortly after, Soony Console Suppliers Ltd refuse to deliver the consoles. Bob is concerned that Gaming Hardware Ltd will also refuse to deliver the goods.

Advise Vic and Bob. Discuss the position under both the common law and statute. Would your answer differ if Vic and Bob had purchased an off-the-shelf company?

Introduction

- Point out that this problem involves the discussion of the validity of pre-incorporation contract and, as the question instructs, you will discuss the legal position under the common law and the CA 2006.

Common law

- The common law rules operated based upon technical and artificial distinctions relating to the manner in which the promoter signed the contract.
 1. Where a promoter entered into a contract signing the contract as the company's agent, or on behalf of the company, the promoter would be held personally liable for the contract.⁵
 2. However, where the promoter entered into the contract by signing the contract using the company's name or merely adding his own name to authenticate that of the company's, then the supposed contract will be held to be with the non-existent company and therefore no contract at all.⁶
- The contract between Vic and Soony Console Suppliers Ltd would come under the first type as he signed the contract 'for and on behalf' of the unformed company. Therefore a contract would exist between Vic and Sony Console Suppliers Ltd, and if Sony Console Suppliers Ltd refused to supply the consoles, it would be in breach to Vic personally.
- The contract between Bob and Gaming Hardware Ltd would be the second type as he signed the contract using the company's name and he simply added his signature for authentication. Therefore the contract would be a nullity and if Gaming Hardware Ltd decided not to fulfill its obligations, Bob would be unable to sue for breach.
- Under the common law, ratification did not affect the outcome.

Statute

- The common law distinctions were abolished by the CA 1985, s 36C and the current provision is found in the CA 2006, s 51(1) which now states that the promoter will be personally liable, irrespective of whether he signed the contract in the company's name or on behalf of the company. Accordingly, third parties can enforce the contract directly against the promoter.

⁵ *Kelner v Baxter* (1866) LR 2 CP 174.

⁶ *Newborne v Sensolid* [1954] 1 QB 45 (CA).

- Does this protection swing both ways (that is, can the promoter enforce a contract where s 51 applies)? The case of *Braymist Ltd. v Wise Finance Co Ltd* established that it does. However. The fact that the courts had to clear this up is an indication of a flaw in the drafting of s 51(1).
- Under statute, it is still the case that the company cannot ratify the contract to make it its own – this is arguably another flaw of s 51.

Section 51 and 'off the shelf' companies

- If promoters make a contract before buying a company off the shelf, s 51 will not apply if the company they buy was in existence at the time the contract was made. Therefore, if Vic and Bob made these contracts at the time when Hampshire Gaming Ltd was incorporated, then s 51 will not apply and the contract will be valid and the company can ratify them.